

# 5. The public finances and sterling

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## Summary

- Currency crises often go hand in hand with fiscal crises, and international investors have become concerned about the UK's public sector debt dynamics.
- In 2008–09, sterling registered an even larger depreciation against the US dollar than in its 1967 devaluation, the 1976 IMF crisis and its 1992 exit from the European Exchange Rate Mechanism. In trade-weighted terms, the decline was the biggest since figures were first calculated in the early 1980s. This large depreciation was driven partly by concerns about the sustainability of the public finances.
- Despite the large projected rise in the government debt stock, the cost of borrowing remains low, assisted by quantitative easing. The latter is likely to be temporary, however, and the cost of the debt burden is set to increase.
- Our central expectation is that debt costs will not become unmanageable and we expect the UK's credit standing to remain strong, notwithstanding the prospective rise in the share of tax revenue that the UK government will have to devote to debt servicing.
- Even so, sustainability cannot be taken for granted: there are plausible scenarios in which the UK's debt sustainability measures stray uncomfortably close to concerning levels. To minimise the risks of a further disruptive fall in sterling, it is crucial that the authorities do all they can to reassure financial markets that both fiscal and monetary probity will be maintained.

## 5.1 Introduction

Currency crises and fiscal crises often go hand in hand. Probably the most common question asked by investors, especially overseas investors, is whether the UK's public finances are sustainable and, by extension, whether there is a risk of a sharp drop in sterling. In this chapter, we examine the interaction between the public finances and the currency, and assess the risk that a negative debt dynamic could lead to a precipitous fall in the value of the pound.

It is obvious why overseas investors would worry about a sharp drop in sterling – the value of their investments would fall when measured in their own currency. But how concerned should UK citizens be about a weaker pound? On one level, sharp currency falls can be seen as 'helpful' – indeed, the Governor of the Bank of England has described the recent fall in sterling as just that.<sup>2</sup> This is based on the view that sterling had previously been overvalued, leading to an imbalance in UK economic growth with

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<sup>1</sup> This chapter draws on analysis, comments and suggestions from my colleagues Moyeen Islam and Paul Robinson.

<sup>2</sup> <http://www.journallive.co.uk/north-east-news/todays-news/2009/09/24/governor-mervyn-king-backs-north-s-export-potential-61634-24767811/3/>.

domestic demand being 'too strong' and external demand 'too weak'. The fall in sterling would help to correct this imbalance.

However, a sharp fall in sterling is not without its costs. Most immediately, import prices are likely to rise, and for economies such as the UK that have high levels of import penetration this means that real household incomes are likely to be squeezed. Also, to the extent that currency volatility adds to uncertainty about the future value of the currency, overseas investors are likely to demand a higher return on their UK investments. The UK's long-term recourse to overseas borrowing (the UK has run a current account deficit almost continuously since the mid-1980s) suggests the costs are likely to be non-negligible.

In Section 5.2, we set out the main insights from academic studies of currency crises, and ask whether a sterling crisis could be said already to have occurred. In Section 5.3, we consider the risks of a further currency fall, which we believe are intimately tied to the perceived sustainability of government debt. Section 5.4 concludes.

## 5.2 The origins of currency crises

The academic literature on currency crises has identified three broad types. So-called 'first-generation' models viewed currency crises as the inevitable consequence of incompatible monetary and fiscal policies. Suppose, for example, that a country's fiscal position had deteriorated to the extent that the central bank found itself printing money to finance the public deficit while at the same time attempting to defend a fixed exchange rate. As the central bank expanded credit, this would put downward pressure on domestic bond yields and prompt investors to switch into foreign bonds, depleting the central bank's foreign exchange reserves. With a finite stock of reserves, this situation cannot be sustained indefinitely and the currency peg would come under pressure.

First-generation models have provided two key insights. First, the exhaustion of reserves is likely to happen suddenly, not gradually, as financial markets anticipate the collapse of the currency peg. In other words, when the inconsistency of policy becomes apparent, the currency is subject to a speculative attack. Second, it is *expected future* public deficits that matter rather than past deficits. As a result, expectations that, for example, the government might have to step in to ensure the solvency of private agents – such as banks – can provoke a currency crisis even if the government is not initially running a budget deficit. By the same token, expectations that the government will act to reduce the deficit can forestall a crisis even if the starting position for the public finances is poor.

First-generation models describe accidents waiting to happen. By contrast, second-generation models depict crises that are self-fulfilling, the result of the economy lurching from a 'good' equilibrium to a 'bad' equilibrium. Suppose that a country is maintaining a fixed exchange rate and has a large amount of foreign currency borrowing. So long as foreign investors see little chance that the country will abandon the peg, it will face low borrowing costs. However, if investors begin to fear a devaluation, they will increase the risk premium on the country's debt and its borrowing costs will rise. Higher borrowing costs reduce output growth in the economy, increasing pressure on the authorities to allow the currency to depreciate. At some point, the pressure may become too great to resist and the peg is abandoned, validating investors' expectations. These models highlight the importance of market sentiment in driving currency movements relative to economic fundamentals.

Third-generation models emphasise the role of the financial sector in causing currency crises. These models focus on the risks inherent in a banking system that has both maturity and currency mismatches. In effect, bank runs can take on an international dimension if a loss of confidence causes foreign investors to withdraw funds and the currency suffers the consequences.

A couple of lessons from this literature are particularly pertinent to the UK at present:

- First, large and widening public deficits and high public exposure to a distressed financial system are likely to be a major source of concern for investors. Monetary policy is also important, and the UK's foray into uncharted quantitative easing (QE) territory has also made some investors wary, and helps explain why sterling has been in the spotlight.
- Second, communication with financial markets about fiscal consolidation plans matters if the authorities are to minimise the risk of a shift in expectations and a lurch into a bad equilibrium.

Models of currency crises normally involve fixed exchange rate regimes, so they might not appear immediately relevant to countries such as the UK with a floating exchange rate. However, we would consider any steep and sudden fall in the currency as potentially worthy of the 'crisis' label, the fundamental point being that a sizeable currency depreciation was needed to bring a halt to unsustainable economic dynamics. Clearly, foreign investors would incur losses in domestic currency terms on their holdings of sterling assets whatever the precise mechanisms of the depreciation.

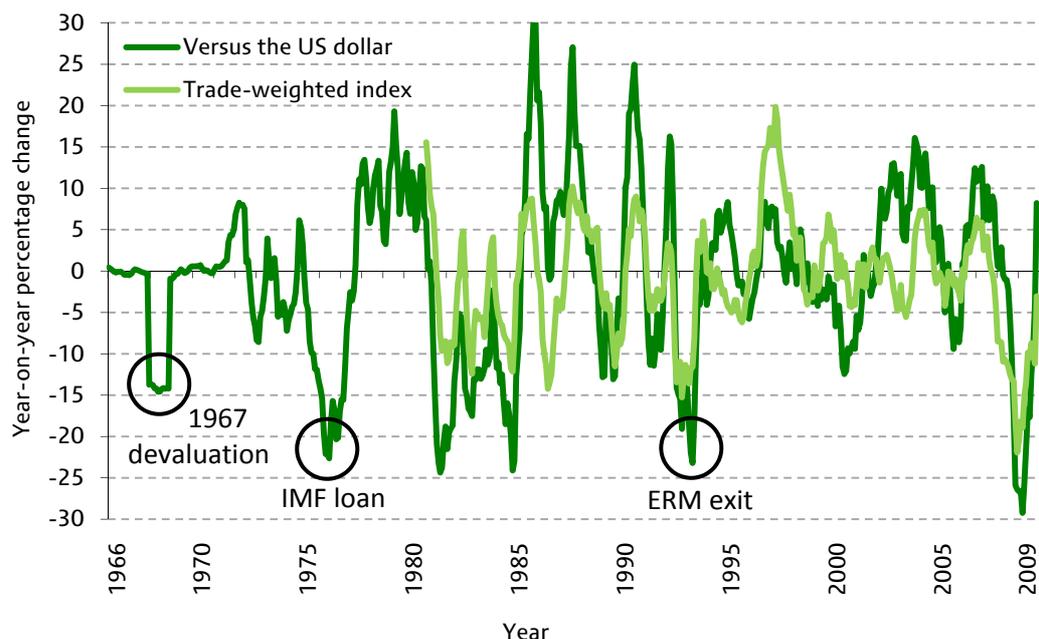
The absence of a fixed exchange rate regime for sterling, however, probably makes the third-generation crisis models less pertinent. A fixed exchange rate can provide the foundation for an excessive build-up of currency mismatches between borrowing and lending, either within the banking system or in the economy more broadly. This has become a source of concern in a number of Eastern European economies, for example, that have pegged their currencies to the euro as part of a convergence drive, prompting their resident firms and households to borrow in euros despite their income being in the domestic currency. Such mismatches are not a major feature of the UK economy.

### **The sterling crisis of 2008–09?**

In the empirical academic literature, it has become the accepted custom to define a currency crisis as a year-on-year fall of 25% or more against the US dollar. Using this criterion, there has only been one sterling crisis in the past 50 years and that occurred between March 2008 and March 2009 when the value of the pound fell by nearly 30% against the US dollar (Figure 5.1). On a trade-weighted basis, which brings into play how the pound has fared against the euro (and its predecessors), sterling was down by 22% year-on-year in December 2008, easily the sharpest fall since these data began in the early 1980s. By way of contrast, the UK's high-profile departure from the European Exchange Rate Mechanism (ERM) in 1992 involved a 23% devaluation against the dollar in the year to August 1993 and a 15% devaluation on a trade-weighted basis in the year to February 1993. From this perspective, the debate about whether a sterling crisis is looming appears somewhat belated: the sterling crisis has already happened.

Economists have generally shied away from labelling the recent fall in the pound a currency crisis. However, a closer investigation of the features of past sterling crises provides no compelling reason to distinguish between these events and the recent drop.

Figure 5.1. Sterling exchange rates



Sources: Haver Analytics and Barclays Capital.

Three episodes over the past 50 years are generally referred to as sterling crises – the devaluation of 1967, the 1976 IMF crisis and the 1992 ERM crisis. In 1967 and 1992, the UK was operating a fixed or quasi-fixed exchange rate regime and so devaluation came as a discrete event, the culmination of pressure that had been building in the wider economy for some time. It seems highly likely that, had sterling been fixed prior to the current episode, a discrete depreciation would have occurred and the ‘crisis’ label would already have been applied.

Events in 1976 arguably have a closer parallel to the present situation. Sterling was floating and so there was no step depreciation, although the pound fell by 23% over the year to June 1976 against the US dollar. The crisis-defining event instead was the UK’s unprecedented application for an IMF loan in September 1976 – although it might also be argued that the fact that inflation had risen to nearly 27% in 1975 gave the 1976 episode an extra edge.<sup>3</sup>

The current situation has not had a single defining event. Also, it could be observed that many currencies have seen sharp falls against the US dollar recently – the Australian and New Zealand dollars, the Brazilian real, the South African rand, the Mexican peso, the Norwegian krone and the Swedish krona all dropped by more than 25%. However, this largely reflected a global liquidity panic, which caused investors to flood into US dollars, whereas the weakness in sterling pre-dated the most acute global liquidity concerns and has persisted even as those concerns have abated. Also, these countries did not have the concomitant public finance and banking sector crises that have hit the UK.

All three previous sterling crises were accompanied by concerns about the public finances. However, the peaks in the public deficit of 4% (1967–68), 7% (1975–76) and 7.7% (1993–94) of national income fell far short of the present situation in which the

<sup>3</sup> The sharp declines in the sterling–US-dollar exchange rate in 1981 and 1985 were the result of dollar strength, as US monetary policy was tightened sharply under Paul Volcker, rather than sterling weakness.

peak deficit is likely to be around 13%. From this perspective, the fall in sterling during 2008 and the early part of 2009 was as much a crisis as any of these other dismal landmarks in the UK's economic history.

### 5.3 The risks of another sterling crisis

The important question now is not whether there has been a crisis but how likely it is that sterling drops significantly further. In this section, we assess how close the public finances are to the sustainability threshold and consider the factors that are likely to influence market perceptions of the UK's debt dynamics.

For many UK citizens, it would seem unthinkable that the UK government would renege on its borrowing, and history is on the side of this viewpoint: the UK has not defaulted on its debt since the 14<sup>th</sup> century. An outright default is not, however, the only recourse open to troubled sovereign borrowers. Rescheduling agreements may be sought before the point of default is reached. Moreover, a government may seek to reduce the real value of its debt by generating high rates of inflation (Henry VIII oversaw a large-scale debasement of the currency, effectively defaulting on the Crown's domestic debts)<sup>4</sup> – although the UK's inflation targeting regime, together with the fact that around a quarter of UK government debt is inflation-linked, means that this is not so obvious a route for the UK at the present time.

However, given the current stressed state of the economy, it can at least be argued that the risks of a fiscal crisis are heightened. An IMF study of debt sustainability,<sup>5</sup> written long before the current crisis, identified a number of features of an economy that, in the experience of IMF staff, should trigger warning lights about the fiscal outlook. These included reliance by the government on efficiency savings, windfall taxes, asset sales and fiscal responsibility laws to project an improvement in the fiscal position. The UK government has made reference to all of these measures when outlining plans for reducing the deficit, so it is little wonder that some investors remain sceptical and have stressed the need for the government to be more specific about its intentions.

#### UK government debt sustainability

Although the recent crisis episode makes it easy to raise vague concerns about the risks to the UK's debt situation, it is worth trying to establish more formally how close the fiscal position is to the sustainability threshold. Such a task is far from easy, but a first-pass assessment is, we think, illuminating.

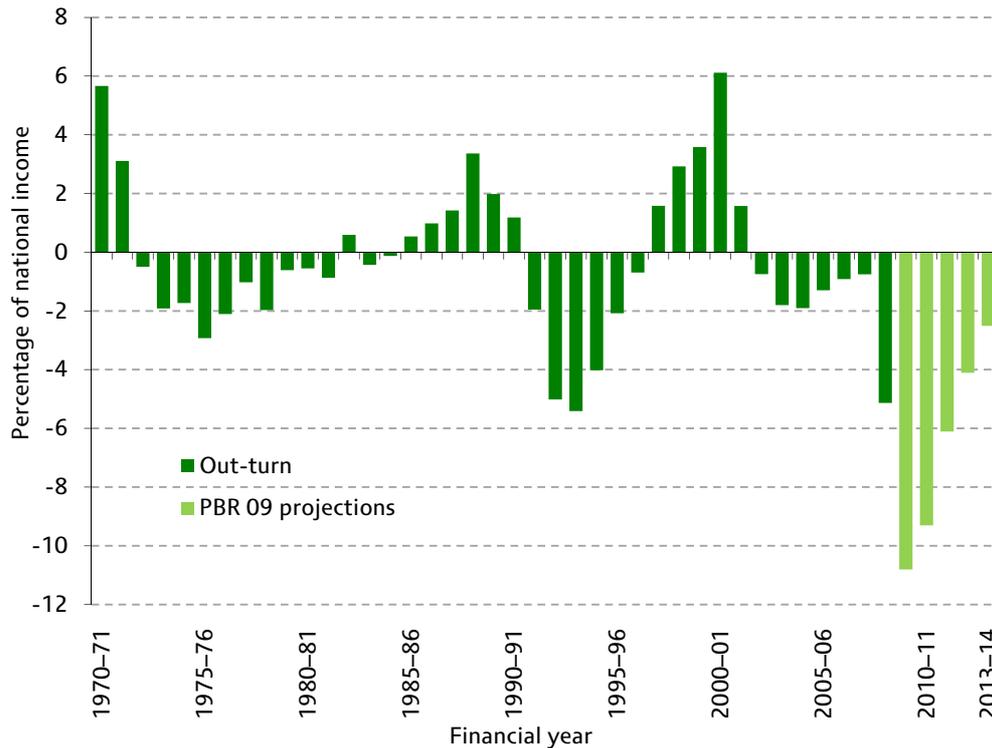
If, in the medium term, the government runs a primary balance (i.e. total public spending excluding debt interest payments is equal to total public sector receipts), the public debt ratio will be stable or falling if the real interest rate on government debt is equal to or less than the economy's trend rate of growth. On current market yields, we estimate that the weighted average real cost of government debt is very low – around 0.9%. This, however, is depressed somewhat by the very accommodative stance of monetary policy at present; we estimate that it will rise to around 1½% in two years' time as the Bank of England moves to a more 'normal' policy setting.

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<sup>4</sup> C. M. Reinhart and K. S. Rogoff, *This Time is Different*, Princeton University Press, Princeton, NJ, 2009.

<sup>5</sup> 'Assessing sustainability', IMF, 28 May 2002, <http://imf.org/external/np/pdr/sus/2002/eng/052802.htm>.

Figure 5.2. Primary budget balance



Sources: Haver Analytics, HM Treasury and Barclays Capital.

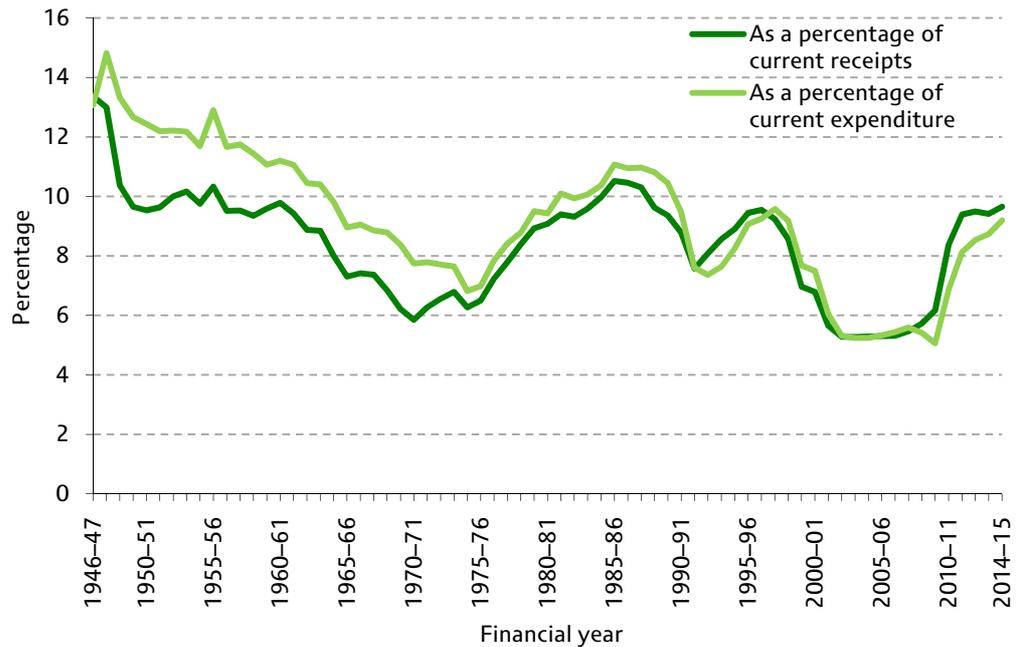
The UK's long-run trend rate of growth is generally thought to be around 2½%, a level that provides plenty of headroom relative to our expectation for the real cost of debt. However, in Chapter 4, we present evidence that trend growth over the next several years is likely to be lower than the historical average. Our central view is that it will be around 2%, but it could be as low as 1¾%. If the latter were the case, the UK would be left uncomfortably close to the sustainability threshold. Certainly, there are plausible scenarios in which questions could be raised about the stability of the public debt stock.

On our central view, however, the gap between trend growth and the real cost of government borrowing means that the government could run a primary deficit of around 1% of national income and still satisfy the solvency condition. The UK's starting position is not good, with the Treasury projecting a primary deficit of nearly 11% of national income in the current fiscal year (Figure 5.2). However, on average since 1970, the UK has run a primary deficit of just 0.3% of national income. Moreover, from 1997 to 2001, there was a primary surplus averaging more than 3% of national income on the back of some fairly dramatic fiscal tightening, indicating that a much tighter fiscal stance is certainly feasible.

The starting position matters, however, because even with fairly aggressive fiscal tightening, the UK is unlikely to achieve a primary balance for several years at least, with the Treasury forecasting a primary deficit of 1.1% of national income even in 2014–15. This re-emphasises the value of a credible plan to bring spending closer in line with revenues in the medium term if financial markets are to remain persuaded of the government's fiscal probity.

Another way of gauging debt sustainability is to see how the government's debt interest payments compare with total current receipts and expenditures. The ratio of interest

Figure 5.3. Central government debt servicing costs



Sources: HM Treasury and Barclays Capital.

payments to receipts is often used as an 'affordability' measure by ratings agencies, for example. For a triple-A rated sovereign, a ratio above 10% is commonly taken as an 'amber warning light' of potential problems. By contrast, comparing debt interest payments with government expenditure gives an idea of the opportunity cost, in terms of forgone public services, of the debt burden. Beyond some level, it may become politically unpalatable to devote such a large fraction of expenditure to debt repayments.

Figure 5.3 plots these two ratios over the post-war period. What is striking first of all is how low the two had been in recent years, at little more than 5%. This reflects the fact that prior to the crisis, the UK had reduced its public debt and interest rates had also been historically low. The economy therefore began from a position in which the 'affordability' and 'acceptability' of debt interest were not in question.

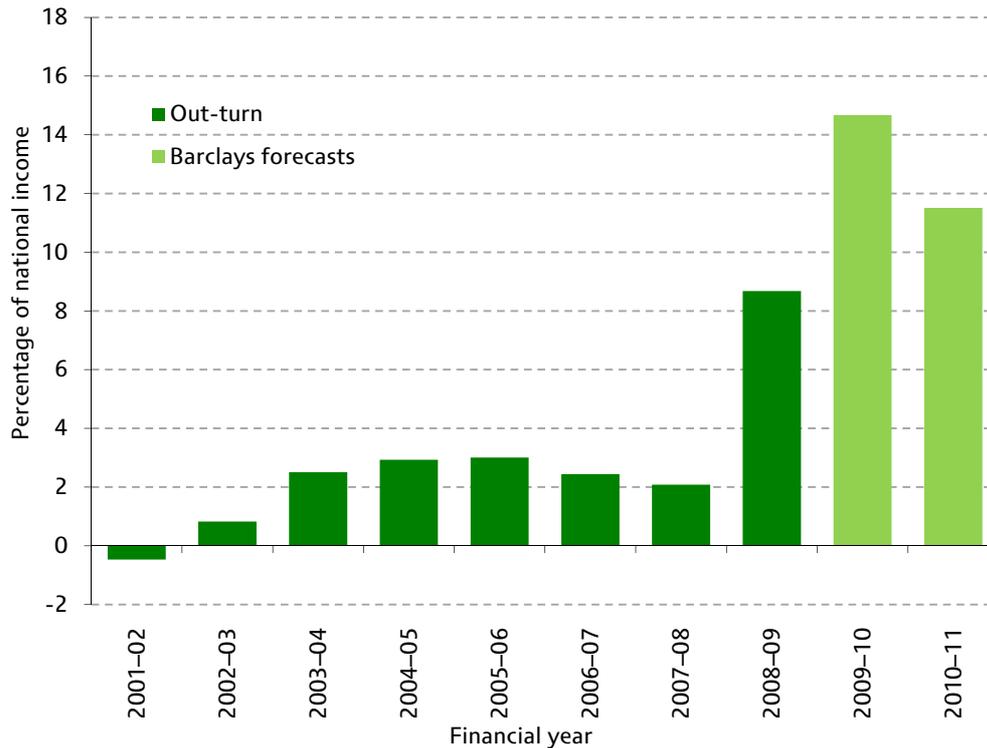
Figure 5.3 also shows estimates of how these ratios would rise if the public finances follow the path set out in the December 2009 Pre-Budget Report (PBR). Both are projected to increase sharply, with the ratio of interest payments to current receipts projected to rise to 9.7% in 2014–15. Even on the Treasury forecasts, therefore, these measures are bordering on concerning levels.

So long as debt costs stay low, it is highly unlikely that the UK will face a financing crisis. On the other hand, given the heavy gilt issuance programme, if gilt yields were to rise sharply this would quickly show up in higher government debt financing costs. One particular source of market concern is the effect of the Bank of England's intervention in the gilts market under its quantitative easing policy.

#### *Quantitative easing and the demand for gilts*

The Bank of England's asset purchase programme has seen it buy around £200 billion of gilts since March 2009, similar to the amount of gilts issued by the UK Debt Management Office (DMO) over the same period. In other words, despite the large scale of government borrowing last year, the net supply of gilts to the private sector over this period was zero.

Figure 5.4. Net issuance of gilts



Sources: DMO and Barclays Capital.

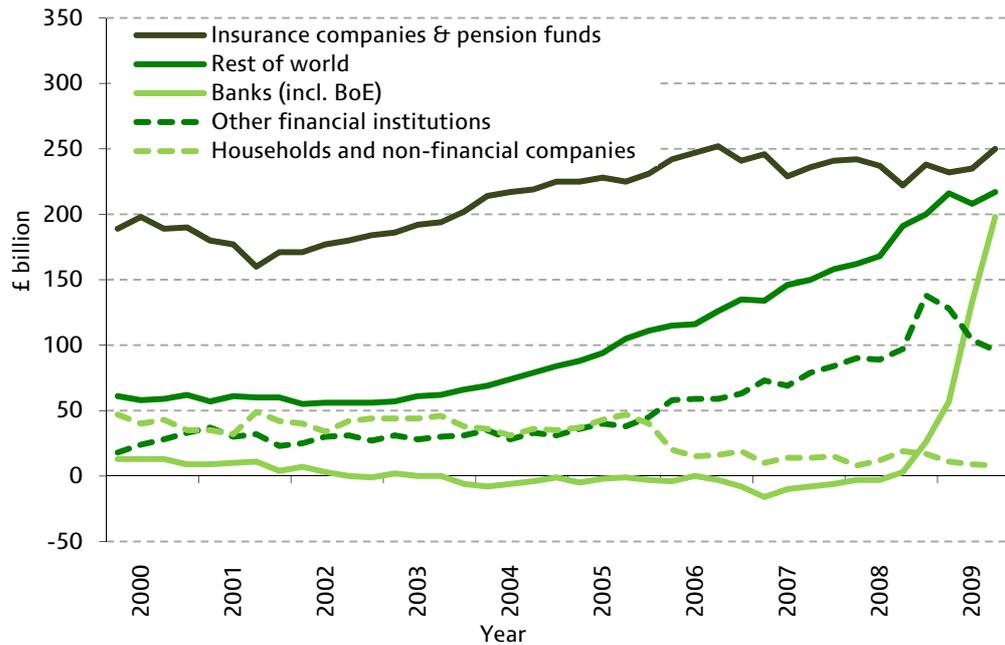
This is set to change dramatically this year. QE purchases may have already halted – at the very least, they are unlikely to proceed at anything like the pace seen in 2009. Moreover, at some point this year, the Bank of England may look to reverse its purchases and sell gilts to private investors alongside the DMO’s primary issuance programme. For example, if the Bank of England were to sell, say, £50 billion of its gilt holdings in 2010–11, together with the DMO’s issuance plans this would mean net supply to the private sector of around £260 billion. At more than 18% of national income, not only would this be a huge turnaround from the zero net supply in the current year, but we would also note that prior to 2008–09 net issuance had never risen above 3% of national income – see Figure 5.4. It is unsurprising, therefore, that some commentators have questioned the market’s ability to absorb such a quantity of debt, and have pointed to a heightened risk of uncovered auctions and a spike in yields.

The Treasury, however, is confident that there will be sufficient demand for gilts and that selling such large quantities will not be a problem. Senior Treasury official Dave Ramsden has described the ‘structural’ demand for gilts from asset managers as ‘strong’, and argued that new liquidity regulations that would require banks to hold more government bonds will help to absorb the additional supply. He concluded that ‘there is good demand out there and that demand will continue’.<sup>6</sup>

It is important to bear in mind, however, that the ultimate sustainability of the government’s debt position depends on medium-term financing costs, not the costs in any one year. So long as any disruption to the market from QE sales is temporary, its

<sup>6</sup> Uncorrected transcript of oral evidence, taken before the House of Commons Treasury Committee, 16 December 2009, <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/uc180-iii/uc18002.htm>.

Figure 5.5. Sectoral holdings of gilts



Sources: Haver Analytics and Barclays Capital.

effect on the sustainability of the public debt position is likely to be small. Indeed, the Bank of England has argued that any temporary rise in debt costs incurred during QE sales needs to be set against the artificially low yields at which the DMO has been able to issue during the QE purchase phase.<sup>7</sup> More important is the question of whether the large rise in the supply of gilts over the next few years is likely to lead to a sustained rise in gilt yields.

Any rise in yields that might be prompted by this turnaround in effective gilt supply could be mitigated if a new source of demand for gilts were to emerge. Figure 5.5 shows how sectoral holdings of gilts have evolved over time. The Bank of England's purchases under its QE programme are clearly evident. Aside from these, the most striking trend has been the rise in overseas gilt ownership, which has risen from around £60 billion in 2000–03 to nearly £220 billion in 2009 Q2. This has left overseas investors holding only slightly less than domestic institutional investors.

However, the rise in overseas gilt holdings coincides with a period in which the holdings of sterling reserves by foreign central banks were also rising. According to the IMF, global reserves in sterling rose from \$34.1 billion in 1998 to \$184 billion in 2009 Q2, with the share of sterling in global reserves increasing from around 2% to more than 4%. This suggests that much of this demand reflects asset allocation decisions by reserve managers at central banks rather than a surge in overseas institutional interest in sterling government bonds. In our view, this reallocation has largely run its course and so although we would expect overseas buying of gilts to continue, we see no reason to expect a step-up in foreign demand to substitute for gilt purchases by the Bank of England.

<sup>7</sup> 'Quantitative easing: an interim report', speech by Charles Bean, Bank of England Deputy Governor, 13 October 2009 ([www.bankofengland.co.uk/publications/speeches/2009/speech405.pdf](http://www.bankofengland.co.uk/publications/speeches/2009/speech405.pdf)).

Several commentators have suggested that the extra supply of gilts will be absorbed by banks as a result of the new regulatory liquidity regime. The Financial Services Authority (FSA) is in the process of implementing new regulations relating to banks' holdings of liquid assets. The regulations are based on stress scenarios in which firms experience significant outflows across several sources of liquidity (e.g. wholesale and retail deposits), which are then required to be met only by liquidating high-quality government bonds (i.e. without recourse to emergency central bank funding). Monetary Policy Committee (MPC) member David Miles has suggested that banks' need to hold more gilts may be one way in which 'QE can naturally roll-off'.<sup>8</sup>

We would be cautious, however, in assuming that the new liquidity regulations will produce a large boost to gilt demand. There is no clarity yet about how large banks' government bond-holdings are going to be, since the liquidity requirements are tailor-made and the details are yet to be finalised. When the new regime was announced, the FSA gave a tentative estimate that banks' holdings of government bonds would need to rise by £110 billion. If this were all gilts, the change would clearly be material. However, banks' holdings of bonds have to match the currency denomination of their liabilities and less than half of UK banks' liabilities are in sterling. Although the new liquidity regime might account for some of the additional gilt supply, it is likely to be only a fraction of the solution to the problem.

A third potential source of higher demand for gilts comes from domestic residents. There is a widespread belief that households in particular have saved too little in recent years and become excessively exposed to housing. The financial crisis may therefore act as a 'wake-up call' to consumers to save more and allocate more of their savings to financial assets. Household savings have increased sharply: the saving ratio rose from -0.7% in 2008 Q1 to 8.6% in 2009 Q3. However, households' accumulation of financial assets has remained weak, whereas purchases of housing assets have remained fairly robust. In fact, households' direct holdings of gilts have been declining for most of the last five years and there has been no sign from the recent data that demand has picked up.

Domestic institutional investors – insurance companies and pension funds – have been the traditional mainstay of the gilt market, accounting for around half of all gilt holdings. In broad-brush terms, there are two developments that might drive stronger demand for gilts from these investors: a rise in household saving through these vehicles; and a portfolio reallocation by institutional investors towards gilts and away from other assets. As we have just noted, the rise in household saving has not so far shown up in stronger financial asset accumulation. Also, we see no reason to expect a secular reallocation towards gilts. Rather, we would expect the demand for gilts to increase only if yields rise, which then begs the question of how much of a rise in yields the market is likely to demand to absorb the extra supply.

When we have examined the recent experiences of other European countries that have seen a surge in debt issuance, we have not found the effect on yields to be worryingly large – on average, we found that a 10 percentage point rise in a country's ratio of public debt to national income was associated with a rise in funding costs of just 0.16 percentage points.<sup>9</sup>

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<sup>8</sup> 'Money, banks and quantitative easing', David Miles, Bank of England, 14 September 2009, <http://www.bankofengland.co.uk/publications/speeches/2009/speech404.pdf>.

<sup>9</sup> L. Boone, *The Effect of Rising Public Indebtedness on Spreads*, Barclays Capital, 16 December 2008.

### *The UK's sovereign credit rating*

Another concern that has been raised is that the bond rating agencies might downgrade UK government debt from its current triple-A rating. A sovereign downgrade would be likely to increase debt costs as some asset managers are restricted in the amounts of funds they are allowed to allocate to investments rated below triple-A. A downgrade would mean the UK would lose access to this source of funds.

On 21 May 2009, Standard & Poors revised the outlook on the UK sovereign rating to 'negative' from 'stable' on the view that the public debt ratio may approach 100% and not show any appreciable decline in the medium term. This was the first time since the UK was initially rated by S&P in 1975 that the outlook has been anything other than 'stable'. The other major rating agencies, Moody's and Fitch, have also highlighted the formidable fiscal challenges the government faces, although they have retained a 'stable' outlook on the UK's triple-A rating.

As discussed in Chapter 1, Barclays' forecasts for the macroeconomy are more downbeat than those of the Treasury, and in Chapter 6 we report that in our central case we see the public debt ratio rising to 85.5% in 2014–15, appreciably higher than the 77.7% in the PBR. Even so, we do not expect the UK to lose its triple-A rating. There are a number of reasons for this:

- Credit ratings are relative measures, and several other large, developed countries (not least the US) have seen their public finances deteriorate. The relative deterioration in the UK's position has been rather less than the deterioration in absolute terms.
- Although the main political parties may disagree on the precise form and timing of fiscal consolidation, the need for consolidation is widely accepted by politicians, and seems to be widely appreciated by the general public.
- Even on our 'pessimistic' economic scenario, we project the public debt ratio to fall short of 100% (see Chapter 6), the level cited by S&P.
- Pessimism about the public finance outlook arguably reached its nadir in the first half of 2009 and has since improved somewhat. The financial and property sectors have generated more revenue than had been expected, and the degree of banking sector support has turned out to be rather less than thought at the time, with Lloyds Banking Group deciding not to take advantage of the government's Asset Protection Scheme and Royal Bank of Scotland reducing its participation relative to the initial plans. Unemployment has risen appreciably less than had been feared.

In our view, the one recent fly in the ointment with regard to the UK's credit rating was the PBR itself, in which the government raised its projections for tax revenue, partly reflecting new tax measures, but allocated the funds to additional spending rather than to reducing the deficit. The rating agencies are unlikely to have found this reassuring.

With regard to debt costs, our bottom line is that gilt yields are likely to rise – for example, we see the 10-year gilt yield increasing from its current level of around 4% to around 5% over the next year or two (although longer-term borrowing costs are likely to rise by less) – and this will add to the government's debt servicing costs. However, the increase should not be sufficient to tip the public finances into a self-generating debt spiral, and we expect that the UK will survive with its triple-A credit rating intact.

## 5.4 Conclusion

The history of currency crises suggests that investors are right to scrutinise the UK. The deterioration in the public finances, the problems in the banking system and the adoption of 'unconventional' monetary policy are all good reasons to ask questions about the soundness of the pound. However, sterling has already fallen a long way and our analysis suggests that, although debt costs are set to rise, the sustainability of the public debt position is not immediately under threat.

There are two main caveats to this benign assessment. First, the authorities need to be wary of financial market dynamics. Adverse shifts in market sentiment can lead to self-fulfilling crises, almost regardless of the state of the underlying fundamentals. The UK authorities need to ensure that investors have no reason to reappraise their view of the UK's creditworthiness.

Both fiscal policy and monetary policy matter here. Regarding fiscal policy, it is difficult to overstate the importance of clear and credible plans for fiscal consolidation. The markets are likely to be expecting concrete details to be announced after the general election, whoever forms the government. On monetary policy, expectations around QE and the inflation target need to be managed carefully. It is all too easy for investors to put unconventional monetary operations together with high and rising public debt levels and conclude that the government might seek to inflate the value of debt away. Strict adherence to an unchanged inflation target is paramount to maintaining the integrity of the currency.

The second caveat is that uncertainty about the growth outlook following the severe recessionary shock means the sustainability of the public finances still cannot be taken for granted. We are assuming that the economy puts in a sustained recovery over the next few years – the Treasury is forecasting an even stronger rebound. If this fails to materialise, however, additional stress will be put on the public finances and the currency could suffer once more.